JUN 13 1945
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

No. 1372 126

AVIATION CAPITAL, INCORPORATED
(In Liquidation),

Petitioner,

against

WILLIAM J. PEDRICK, Collector of Internal Revenue,
Second District of New York.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

FRANCIS H. HORAN
Counsel for Petitioner
Aviation Capital, Incorporated
(In Liquidation)

WEBSTER & GARSIDE
FREDERICK SHEFFIELD
HENRY CASSORTE SMITH
Of Counsel

INDEX

PAGE

PETITION FOR WRIT OF CERTIORARI:

Opinions below ---- 1
Jurisdiction ---- 2
Questions presented ---- 2
Statutes and regulations involved ---- 3
Statement of facts ---- 4
Reasons for granting the writ ---- 6
Conclusion ---- 7

BRIEF IN SUPPORT OF PETITION:

Opinions below ---- 9
Jurisdiction ---- 9
Statement of the case ---- 9
Specification of errors ---- 9
Summary of the argument ---- 10
Argument
I. The decision of the Circuit Court of Appeals crystallizes a situation with respect to repurchase and resale of corporate stock which has received varying treatment in the Treasury, the Securities and Exchange Commission and the courts and which should now be straightened out 11
II. The regulation involved is invalid because Congress, by reenactment of the relevant statute, adopted the predecessor regulation and it continued in effect at the time when the taxes were levied ---- 15
III. Section 22(a) does not support the regulation if the regulation must be interpreted to tax capital transactions ---- 17

PAGE

IV. If the statute does support the regulation, then, to the extent it covers the capital transactions here, it is invalid because not authorized by the Sixteenth Amendment ---------- 17

Conclusion ---------- 18

CASES CITED:

Brewster *v.* Gage, 280 U. S. 327 (1930) ---------- 16

Commissioner *v.* S. A. Woods Machine Company, 57 F. (2d) 635 (C. C. A. 1, 1932), cert. den. 287 U. S. 613 ---------- 16

Eisner *v.* Macomber, 252 U. S. 189 (1920) ---------- 17

Helvering *v.* R. J. Reynolds Tobacco Co., 306 U. S. 110 (1939) ----------7, 15

Irwin *v.* Gavit, 268 U. S. 161 (1925) ---------- 17

Manhattan General Equipment Company *v.* Commissioner, 297 U. S. 129 (1936) ---------- 17

Morgan *v.* Commissioner, 309 U. S. 78 (1940) ---------- 16

Panama R. R. Co. *v.* Johnson, 264 U. S. 375 (1924) 17

Squibb, E. R., & Sons *v.* Helvering, 98 F. (2d) 69 (C. C. A. 2, 1938), modified on reargument 102 F. (2d) 681 ---------- 12

United States *v.* Kirby Lumber Co., 284 U. S. 1 (1931) 17

Winkelman, et al. *v.* General Motors Corporation, et al., 44 F. Supp. 960 (S. D. N. Y. 1942) ---------- 14

PAGE

STATUTES:

Constitution, Sixteenth Amendment ---------- 18
Judicial Code, 28 U. S. C. § 347(a) ---------- 2
Revenue Act of 1936, 26 U. S. C. A. § 22 ---------- 3
Revenue Act of 1938, 26 U. S. C. A. § 22 ---------- 3

MISCELLANEOUS:

SEC Accounting Series, Release No. 6 ---------- 14
SEC Regulations S-X, Art. 5, Rules 3.16, 5.03 ---------- 14
Treasury Regulations 33, Art. 98 ---------- 16
Treasury Regulations 45, Art. 542 ---------- 16
Treasury Regulations 62, Art. 543 ---------- 16
Treasury Regulations 65, 69, 74, 77 ---------- 16
Treasury Regulations 94, Art. 22(a)-16 ---------- 3
Treasury Regulations 101, Art. 22(a)-16 ---------- 3

IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

No.

AVIATION CAPITAL, INCORPORATED
(In Liquidation),

Petitioner,

against

WILLIAM J. PEDRICK, Collector of Internal Revenue,
Second District of New York.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari be issued to review a judgment of the Circuit Court of Appeals for the Second Circuit (R. 116) affirming a judgment of the District Court of the United States for the Southern District of New York (R. 100) dismissing the petitioner's complaint in an action for the refund of alleged income tax deficiencies for the calendar years 1937, 1938 and 1939, paid under protest by the petitioner.

Opinions Below

The opinion of the Circuit Court of Appeals, not yet reported, is printed at R. 109. The opinion of the District Court is reported in 56 F. Supp. 964.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered March 13, 1945. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by Act of Feb. 13, 1925 (28 U. S. C. Sec. 347-a).

Questions Presented

(1) Whether an investment corporation derived taxable income from the resale of its own stock repurchased from stockholders, where:

(a) the charter required such repurchase on request;

(b) mandatory repurchase was a necessary attribute of the stock in order to attract investors;

(c) the repurchase price was fixed by the charter at current liquidation value;

(d) stock was repurchased only when stockholders so demanded;

(e) the resale of the stock was for the purpose of raising much needed capital;

(f) the resale price was always the liquidation value of the stock at the time of resale; and

(g) the purchases and resales were not made pursuant to a plan to make a profit.

(2) Whether Article 22(a)-16 of Regulations 94 and 101 respectively is invalid because its predecessor regulation had been adopted by Congress and was so imbedded in the law as to be alterable only by legislation.

(3) Whether Article 22(a)-16 of the Regulations, here held to reach capital transactions, is valid under Section 22(a) of the Revenue Acts of 1936 and 1938; and

(4) If Article 22(a)-16 of the Regulations is supported by Section 22(a) of the statute, can the latter constitutionally thus reach transactions to raise capital?

Statutes and Regulations Involved

Section 22(a) of the Revenue Act of 1936 (26 U. S. C. A. 22) and Section 22(a) of the Revenue Act of 1938 (26 U. S. C. A. 22) are identical and read as follows:

"§ 22. GROSS INCOME

(*a*) *General definition.* 'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

"(*b*) * * *"

Regulations 94, Art. 22(a)-16 and Regulations 101, Art. 22(a)-16 are identical and read as follows:

"*Acquisition or disposition by a corporation of its own capital stock.*—Whether the acquisition or disposition by a corporation of shares of its own capital stock

gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

"But if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Act."

Statement of Facts

The facts as found by the District Court (R. 92-97) may be summarized as follows:

The taxpayer, a Delaware corporation now dissolved,* was engaged in the business of purchasing, holding, selling and dealing in the securities of aviation companies (R. 92-93). Its charter required it, upon demand, to repurchase its own capital stock at the current liquidation value of its assets (R. 93).

From 1929 to 1939 the taxpayer, always upon demand and pursuant to the above charter provisions, purchased shares of its own stock which it thereafter held in its

* Under the Delaware statutes the taxpayer, although dissolved, continued its corporate existence for the purpose of prosecuting and defending suits and of enabling it to settle and liquidate its affairs (R. 92).

treasury instead of retiring it (R. 93). In 1937, 1938 and 1939 it resold this treasury stock at current liquidation value, which was a higher aggregate amount than it had paid for the stock (R. 94). The treasury stock was resold to obtain much needed additional working capital (R. 95). In each of the years 1937, 1938 and 1939 the taxpayer had available authorized but unissued capital stock which it could have sold in lieu of its treasury stock (R. 95). (If it had sold its authorized but previously unissued stock the very regulations here held applicable provide that no tax be imposed.)

Upon the issue of its stock the taxpayer regularly allocated the sales price thereof in excess of par value to paid-in surplus (R. 94). Upon the purchase of its own stock appellant charged paid-in surplus with the purchase price in excess of par value (R. 94).

The taxpayer in purchasing its own stock handled the transaction on its books differently from the way it handled the purchase of stock of other corporations. In the purchase of other stocks there was no change in the company's net worth, but merely a change in form of assets, from dollars to investments. In the purchase of its own stock there was a reduction of the company's net worth in that the stock so purchased was not carried as an asset or as having any value, although it was not canceled or retired. The company paid itself no dividends on such treasury stock. When the company sold its own stock so acquired, the excess of the proceeds over its par value went to surplus account, increasing the company's net worth. In the sale of other stocks the profit or loss therefrom went into income account. The sale of the treasury stock had the same effect on the books of the company as if unissued stock had been sold (R. 95).

The Commissioner of Internal Revenue, on review and audit of the returns for 1937, 1938 and 1939, determined alleged deficiencies (including interest) for these years of $11,415.36, $10,916.67 and $23,959.36 (R. 95).. These alleged

deficiencies were based upon the difference between the aggregate price at which the taxpayer had reacquired its stock and the aggregate price at which it had subsequently resold the stock (R. 95). After the taxpayer had duly filed protests it paid the alleged tax deficiencies on October 9, 1942 and filed claims for refund on December 3, 1942 (R. 61). This suit for a refund was instituted on September 23, 1943 (R. 9), more than six months having elapsed without action having been taken by the Commissioner in respect of the claims for refund (R. 96).

The District Court, after a trial without a jury, held that taxable gain resulted from the transactions described and judgment was entered for the Collector.

Reasons for Granting the Writ

1. The decision below brings to a head a vexed situation that has been building up since 1934 when the Commissioner of Internal Revenue abandoned his seasoned regulation that a corporation did not derive taxable gain from transactions in its own stock. Having adopted a new regulation, still in effect, that taxable gain could result from such transactions, the Commissioner began to stretch its meaning to cover every sort of transaction in "treasury stock". The lower courts have supported him to the point that one of the concurring Circuit judges characterized this decision as a "singular triumph of form over substance" (R. 115). The regulation now means anything that the Commissioner of Internal Revenue says it means, despite its express provisions that whether such transactions are taxable "depends upon the real nature of the transaction" and whether the corporation is dealing with its own shares in the same manner as though it were dealing in the shares of another. Although of interest to every corporation the question is of prime importance to investment corporations.

The important general question involved—whether a corporation can derive income from the sale of its own stock—has not been passed upon by this Court. For nearly thirty years the Treasury and the lower courts have drifted hither and yon in this important field of taxation. The present state of the law stultifies accepted principles of corporate accounting. The lower courts are evolving curious concepts of corporate income. The confused situation calls for review by this Court.

2. The validity of an important current regulation is in issue. In *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110 (1939), at p. 116, this Court explicitly left open the question whether the predecessor regulation was so imbedded in the law as to require legislative alteration, if alteration was wanted. This unsettled question, anticipated by the Court, is now here and this Court should pass upon it because of its very important bearing on administrative law.

3. As interpreted and administered by the Bureau of Internal Revenue, the regulation here involved is in direct conflict with the rules of the Securities and Exchange Commission in respect of the treatment of proceeds from sale of treasury stock.

CONCLUSION

For the reasons stated the writ should be allowed.

Respectfully submitted,

FRANCIS H. HORAN
Counsel for Aviation Capital, Incorporated (In Liquidation)

WEBSTER & GARSIDE
FREDERICK SHEFFIELD
HENRY CASSORTE SMITH
Of Counsel

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No.

AVIATION CAPITAL, INCORPORATED
(In Liquidation),

Petitioner,

against

WILLIAM J. PEDRICK, Collector of Internal Revenue,
Second District of New York.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

Opinions of the Courts Below

The opinion in the Circuit Court of Appeals for the Second Circuit (R. 116) has not yet been reported. The opinion of the District Court is reported in 56 F. Supp. 964.

Jurisdiction

Reference is made to the petition, p. 2, *supra.*

Statement of the Case

Reference is made to the "Statement" in the petition, pp. 4-6, *supra.*

Specification of Errors

The Court is respectfully referred to that part of the petition which sets forth the questions presented (pp.

2-3, *supra*) and to that part which sets forth the reasons for the allowance of the writ (pp. 6-7, *supra*).

Summary of the Argument

1. This is not an attempt to induce this Court to correct an appraisal of facts. The error below is only an error in fact to the extent that it marks the furthest stretch of a Treasury regulation which has received interpretation in several of the Circuits. The courts have accorded the regulation a breadth it cannot validly have, and hold implicitly that the tax law in this respect is whatever the Commissioner of Internal Revenue says it is. The transactions here were found by the District Court to have been to secure much needed capital. The repurchases were obligatory under the corporate charter and at the current liquidation value which precluded bargaining as to price. The corporation did not treat the treasury stock on its books as it treated other stock. Sales of treasury stock were at asset liquidation value. The sound accounting view, which ought to be given weight in the courts, is that there can be no profit here. The Securities and Exchange Commission adopts the sound accounting view. There is, therefore, a definite conflict between two important government agencies with respect to a basic practice.

2. Our view was that accepted by the Treasury by regulation for fifteen years. By reenactment of Section 22(a) of the Internal Revenue Code, Congress adopted that regulation. The present regulation is therefore invalid because its predecessor was so far imbedded in the law that it could be removed only by Congress.

3. The transactions involved being capital transactions, Section 22(a) of the Internal Revenue Code does not authorize a tax because that statute cannot be construed to cover capital transactions.

4. If Section 22(a) of the Internal Revenue Code must be interpreted to cover these transactions to raise capital,

it is unconstitutional because the Sixteenth Amendment authorizes a tax on income and not a tax on a portion of the capital raised by promoters.

ARGUMENT

POINT I

The decision of the Circuit Court of Appeals crystallizes a situation with respect to repurchase and resale of corporate stock which has received varying treatment in the Treasury, the Securities and Exchange Commission and the courts and which should now be straightened out.

This petition was not filed to induce this Court to correct an error in appraisal of facts. That happened, strikingly. But this Court has not the time merely to straighten out such mistakes.

The present case offers the opportunity to supply valuable guidance to taxpayers and the tax bar with respect to the broad question of a corporation's dealing in its own stock. The fact that in the cases of this type so far litigated in the Circuit Court of Appeals the taxpayer has always lost does not mean that no problem exists; it means that step by step a regulation of doubtful legitimacy has been judicially implemented to the point where, as here, the trial Court can characterize a transaction as one to raise capital (R. 95) and yet find that the corporation's transactions in its own stock had exactly the same aspect as if it were buying and selling cows.

The pious recital of the regulation that taxability "depends upon the real nature of the transaction" and that taxability depends upon whether a corporation "deals in its own shares as it might in the shares of another corpora-

tion" becomes irony when the trend of decision is as it is. This decision is that most pernicious thing, the giving of the form but not the substance of justice.

The District Court found that the petitioner sold its reacquired stock "in order to raise much needed working capital" (R. 95). The transaction was thus a capital transaction. Accordingly, by holding nevertheless that there was a tax due here the Courts have announced a paradox, *i. e.*, that the raising of capital by a corporation is a profit-making venture. The paradox is rendered perfect by the fact that, as found by the District Court, the resale price of the stock was at current liquidation value of the petitioner's assets (R. 95); so the "profit" lay in the enhancement of the value of the assets of the corporation unrealized by it!

This Court has not passed upon the fundamental proposition whether a corporation can profit from the sale of its own stock at liquidation value. Unless tax law is to have its own Pickwickian language, it is absurd to say that such profit can be derived. Our point has been perfectly stated by Judge LEARNED HAND in *E. R. Squibb & Sons* v. *Helvering*, 98 F. (2d) 69 (C. C. A. 2, 1938) (at pp. 70-71):

> "* * * Nevertheless it is very difficult—indeed to us it seems impossible—to understand how the notion of a gain to the corporation from such transactions is legally tenable, except when the sale of the shares is at a price higher than their real value at the time of the sale. Such a belief must depend upon the mistaken supposition that after purchase the shares have an existence as such, and are more than a mere power to issue shares, like authorized, but unissued, shares. This seems to us unsound. Borg *v.* International Silver Company, 2 Cir., 11 F. 2d 147.
>
> "If one regards the corporation as the group of its shareholders collectively, that is very apparent. If they sell 'treasury shares', bought at a lower price, what really happens is that the group has been en-

larged; new shareholders have been added. Always assuming that the shares are sold at their true value, the old group has not profited because the sale of the 'treasury shares' leaves the value of their own shares absolutely untouched. The purchase price received for each 'treasury share' sold will by hypothesis exactly match the value of each old share, and the sold share will neither trench upon, nor leave any margin of profit for, the old shares. All that has happened is that a larger group is doing business with a proportionally increased capital. The same is true also, if the corporation be regarded as a juristic person, stricti juris. Before the sale of 'treasury shares' the corporation is liable to its shareholders in the sum of their claims against it, which equal the net value of its then assets, including any increase in their value during the period when the 'treasury shares' have been held. The corporate assets are of course increased by the sale, but the new shares create new liabilities which will precisely equal the increase, and there can be no profit to the corporation. The only escape from this is to treat the corporation as so completely independent of its shareholders, that its obligations to them should be disregarded in figuring its gains or losses. But to do that would completely distort the corporate income, and charge it as profit with all that it receives when it sells 'treasury shares', and to credit it as loss with all that it pays to purchase them. Indeed, the whole reasoning which supports the emergence of profit from such transactions presupposes that the corporation has relieved itself of an obligation when it buys a share and creates one when it sells one. Since on analysis this appears to be legally untenable, it is plain that the original interpretation of the Treasury was at least permissible. * * *"

It was this statement and Judge HAND's dissent in *Commissioner* v. *Air Reduction Co.*, 130 F. (2d) 145, 148 (C. C. A. 2, 1942), which caused concurring Judge FRANK to say below (R. 115) that:

> "The prevailing rule is a singular triumph of form over substance."

If this corporation had bought and retired its own stock and issued *theretofore unissued* stock when new investors desired to come in, all practical results would have been the same except that this tax would not have been imposed (Reg. 101, Art. 22-a-16). Merely for that reason, purely technical, the Commissioner has levied a tax.

The impropriety of including "income" from sale of treasury stock in the profits of a corporation—because against sound accounting practise and Securities and Exchange Commission standards—is fully demonstrated in *Winkelman et al.* v. *General Motors Corporation et al.*, 44 F. Supp. 960 (S. D. N. Y. 1942) at pp. 989 *et seq.* There it was held that such could *not* be included in the base for corporate officials' bonus, and the judicial narration of the recent history of this problem points with certainty to the answer in this case.

The SEC of course takes another view of the effect of transactions like those here involved. It has ruled (SEC Accounting Series, Release No. 6):

> "It is recognized that when capital stock is reacquired and retired any surplus arising therefrom is capital and should be accounted for as such and that the full proceeds of any subsequent issue should also be treated as capital. Transactions of this nature do not result in corporate profits or earned surplus. There would seem to be no logical reason why surplus arising from the reacquisition of the company's stock and its subsequent resale should not also be treated as capital."

The SEC regulations are consistent with this ruling (see Reg. S-X, Art. 5, Rules 3.16 and 5.03).

Thus two important agencies of the government take diametrically opposite views of our situation.

POINT II

The regulation involved is invalid because Congress, by reenactment of the relevant statute, adopted the predecessor regulation and it continued in effect at the time when the taxes were levied.

Until 1932 the regulations said flatly that a corporation could not make a profit from transactions in its own stock.

Article 22(a)-16 (p. 3, *supra*), representing the challenged change in the regulation made in 1932, is the regulation applicable. In *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110, 114 (1939), the Commissioner tried to apply the new regulation to a transaction completed before its adoption. This was forbidden by this Court. But the question of the validity of the present regulation was explicity left open (at pp. 116-117):

> "* * * We need not now determine whether, as has been suggested,* the alteration of the existing rule, even for the future, requires a legislative declaration or may be shown by reënactment of the statutory provision unaltered after a change in the applicable regulation. As the petitioner points out, Congress has, in the Revenue Acts of 1936 and 1938, retained § 22(a) of the 1928 Act *in haec verba*. From this it is argued that Congress has approved the amended regulation. It may be that by the passage of the Revenue Act of 1936 the Treasury was authorized thereafter to apply the regulation in its amended form. But we have no occasion to decide this question since we are of opinion that the reënactment of the section, without more, does not amount to sanction of retroactive enforcement of the amendment, in the teeth of the former regulation which received Congressional approval, by the passage of successive Revenue Acts including that of 1928."

---

* "*Squibb & Sons* v. *Helvering*, 98 F. 2d 69, 70."

The Commissioner has since 1913 taken many positions of the general problem, and they should be set out here.

Regulations 33, Art. 98 provided that if a corporation resold repurchased stock at a higher price the excess was income.

Regulations 45, Art. 542 and Regulations 62, Art. 543 reversed this position and stated that no gain or loss resulted from the purchase of a corporation's own stock.

Then Regulations 65 provided that no gain or loss resulted from the purchase or sale of a corporation's own stock. This was carried through Regulations 69, 74 and 77. Then in 1932, in *Commissioner* v. *S. A. Woods Machine Company*, 57 F. (2d) 635 (C. C. A. 1), cert. den. 287 U. S. 613, the Commissioner succeeded in stretching his own regulation to cover a "profit" from the receipt of a corporation's own stock in settlement of a claim. The regulations were instantly amended to incorporate directly some of the language of that decision. It is the successor regulation which we assert is invalid, because the predecessor regulation had become a part of the law of the land through reenactment of the statute. It became imbedded in the statute. If the law was to be changed adversely to taxpayers Congress and not the Commissioner should do it.

It is settled law that an administrative interpretation followed, as was the pre-1932 regulation here, by repeated reenactment of the relevant statute becomes the law because Congress has "adopted" it. *Morgan* v. *Commissioner*, 309 U. S. 78, 81 (1940); *Brewster* v. *Gage*, 280 U. S. 327, 337 (1930). For years transactions like those here involved were not taxable, under regulations ripened into law. What had in 1932 became law could not by administrative action be diametrically changed. The reenactment rule and good administration are mocked if a seasoned regulation can overnight be changed into its opposite.

POINT III

Section 22(a) does not support the regulation if the regulation must be interpreted to tax capital transactions.

Section 22(a) (p. 2, *supra*) will not be interpreted toward an invalid result as unconstitutional under the Sixteenth Amendment. *Panama R. R. Co.* v. *Johnson,* 264 U. S. 375, 390 (1924).

In *Manhattan General Equipment Company* v. *Commissioner,* 297 U. S. 129, 134 (1936), this Court said:

> "A regulation which * * * operates to create a rule out of harmony with the statute, is a mere nullity. * * * And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable."

Section 22(a) taxes income. Income is supposed to have a plain and understandable meaning and not a metaphysical one such as satisfies the Court below. See *Irwin* v. *Gavit,* 268 U. S. 161, 166 (1925); *United States* v. *Kirby Lumber Co.,* 284 U. S. 1 (1931); *Eisner* v. *Macomber,* 252 U. S. 189, 206 (1920).

We have shown above (pp. 11-14) the capital nature of this transaction. Regulation or none, the transaction may not be taxed under Section 22(a).

POINT IV

If the statute does support the regulation, then, to the extent it covers the capital transactions here, it is invalid because not authorized by the Sixteenth Amendment.

Because of our argument above (pp. 11-14) based upon the fact that the transactions taxed involved the raising

of capital, we shall only say that if Section 22(a) covers this situation then the Sixteenth Amendment has been breached. The Amendment taxes income, and says:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

CONCLUSION

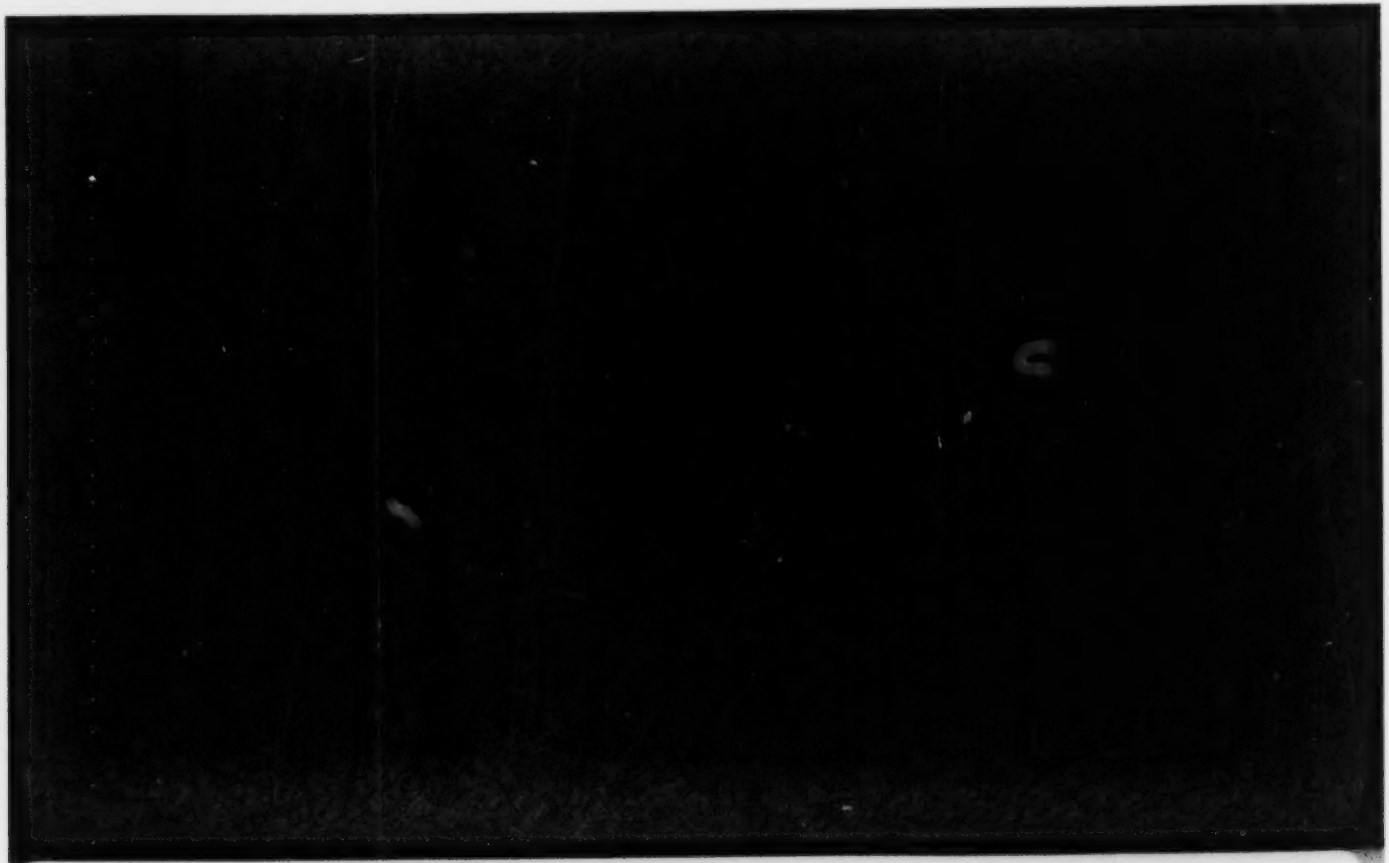
For the reasons stated in the petition and in this brief the application for a writ of certiorari should be granted.

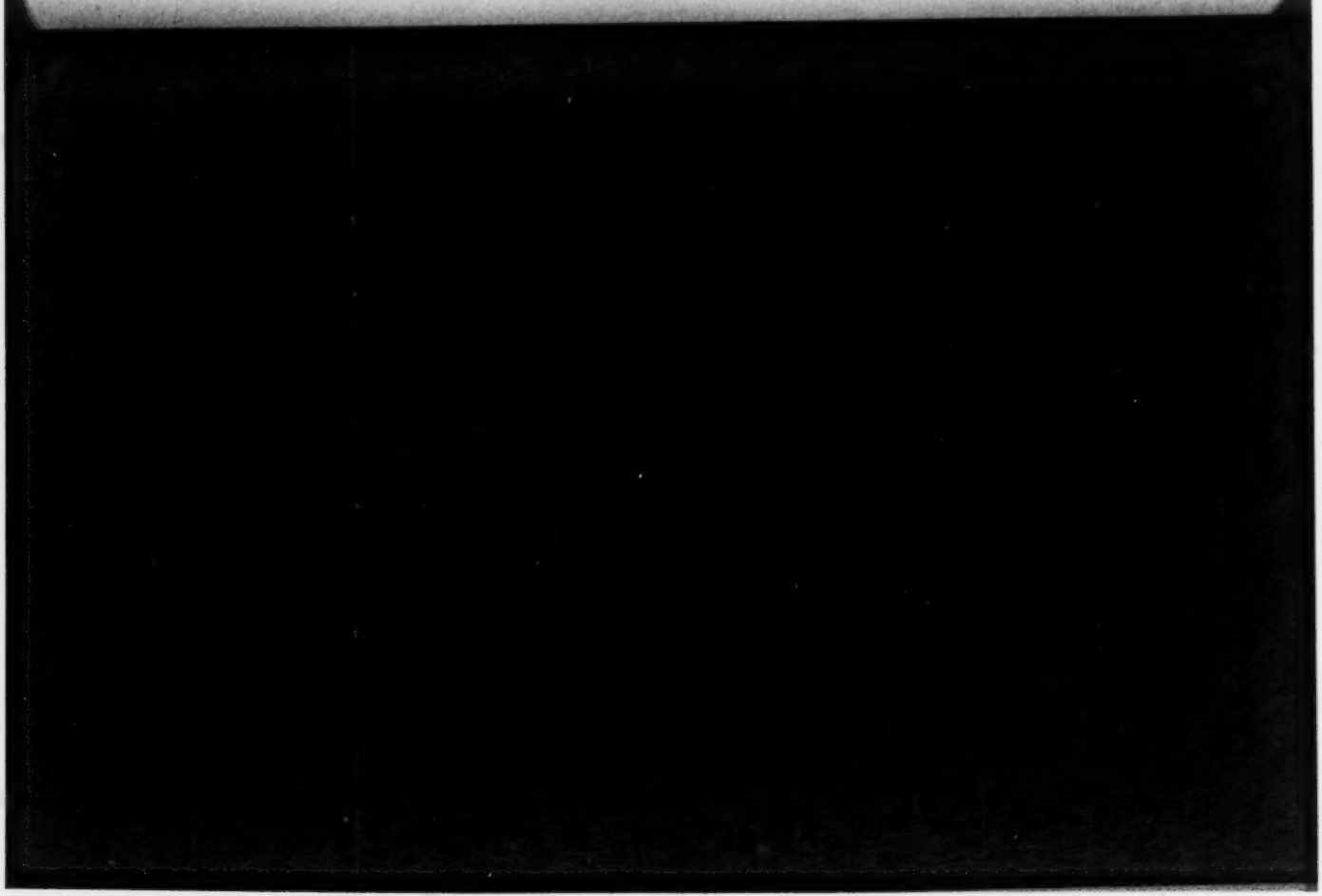
Respectfully submitted,

FRANCIS H. HORAN
Counsel for Petitioner
Aviation Capital, Incorporated
(In Liquidation)

WEBSTER & GARSIDE
FREDERICK SHEFFIELD
HENRY CASSORTE SMITH
Of Counsel

CPY8095





INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes and regulations involved	2
Statement	4
Argument	8
Conclusion	11

CITATIONS

Cases:	
Allen v. *National Manufacture & Stores Corp.*, 125 F. 2d 239, certiorari denied, 316 U. S. 679	8, 10
Commissioner v. *Air Reduction Co.*, 130 F. 2d 145, certiorari denied, 317 U. S. 681	10
Commissioner v. *Sansome*, 60 F. 2d 931, certiorari denied, 287 U. S. 667	8
Commissioner v. *Wheeler*, decided March 26, 1945	8
Commissioner v. *Wilshire Oil Co.*, 308 U. S. 90	11
Dow Chemical Co. v. *Kavanagh*, 139 F. 2d 42	8, 11
Helvering v. *Edison Bros. Stores*, 133 F. 2d 575, certiorari denied, 319 U. S. 752	10
Helvering v. *Reynolds*, 313 U. S. 428	11
Helvering v. *Reynolds Co.*, 306 U. S. 110	8, 10
White v. *Winchester Club*, 315 U. S. 32	11
Wiegand Co. v. *United States*, decided May 7, 1945	11
Statutes:	
Internal Revenue Code:	
Sec. 22 (26 U. S. C. 22)	3
Sec. 115 (26 U. S. C. 115)	8
Revenue Act of 1936, c. 690, 49 Stat. 1648, Sec. 22	2
Revenue Act of 1938, c. 289, 52 Stat. 447, Sec. 22	3
Miscellaneous:	
T. D. 4430, XIII–1 Cum. Bull. 36 (1934)	10
Treasury Regulations 94, Art. 22 (a)–16	3, 9
Treasury Regulations 101, Art. 22 (a)–16	4
Treasury Regulations 103, Sec. 19.22 (a)–16	4

653716—45

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 126

AVIATION CAPITAL, INCORPORATED (IN LIQUIDATION), PETITIONER

v.

WILLIAM J. PEDRICK, COLLECTOR OF INTERNAL REVENUE FOR THE SECOND DISTRICT OF NEW YORK

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 92–99) is reported in 56 F. Supp. 964. The opinion of the Circuit Court of Appeals and the concurring opinion (R. 109–114) are reported in 148 F. 2d 165.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 5, 1945 (R. 114). The petition for a writ of certiorari was filed on June 13,

1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether, on a sale by the taxpayer corporation of shares of its own stock which it had previously purchased, the profit constitutes income within the meaning of Section 22 (a) of the applicable revenue statutes and regulations, when the sale was made to acquire working capital.

2. Whether the Treasury Department had power to promulgate the rule adopted by these regulations as applied to transactions consummated thereafter, notwithstanding the fact that earlier regulations had provided that corporations realized no profit in dealing in their own stock and Congress had previously reenacted the statutory definition of gross income.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.—"Gross income"* includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also

> from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.* * *
>
> * * * * *

The corresponding provisions of Section 22 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and the Internal Revenue Code are identical.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 22 (a)–16. *Acquisition or disposition by a corporation of its own capital stock.*— Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.
>
> But if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration

> upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Act.

Article 22 (a)–16 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, and Section 19.22 (a)–16 of Treasury Regulations 103, promulgated under the Internal Revenue Code, are identical.

STATEMENT

The facts as found by the Tax Court are, in substance, as follows:

The taxpayer, Aviation Capital, Incorporated, was organized under the laws of Delaware on April 20, 1929. On or about August 29, 1942, it was duly dissolved, but by the statutes of the State of Delaware it continued to be a corporate body for the purpose of prosecuting and defending suits, and of enabling it to settle and liquidate its affairs. Prior to its dissolution it was engaged in the business of purchasing, holding, selling and dealing in the capital stock and other securities of aviation companies. (R. 92–93.)

The taxpayer's certificate of incorporation required the taxpayer, upon demand, to purchase its stock from its stockholders at a purchase price

based upon the current net worth of the taxpayer's assets at the time of demand according to a formula therein provided. With respect to such stock, the charter provision provided (R. 93):

> Stock of the corporation acquired by the corporation shall not be thereby cancelled or retired, but may be reissued; provided, however, that the corporation may reduce its stock in the manner authorized by law and effect such reduction by the cancellation and retirement of any shares of its stock held by it.

Pursuant to these provisions, the taxpayer, from 1929 to 1939, purchased shares of its stock which it held in its treasury but later resold, in 1937, 1938 and 1939, for a higher aggregate amount (R. 93).

Upon the issue of its stock by resolution of the board of directors, the taxpayer regularly allocated the sales price thereof in excess of par value to paid-in surplus. Upon the purchase of its stock, the taxpayer charged paid-in surplus with the purchase price in excess of par value. Upon sale of its treasury stock, the taxpayer credited paid-in surplus with the sales price in excess of par value. (R. 94.)

The purchases of its stock were made by the taxpayer only when required to do so by its stockholders, and were in fact made at its current liquidation value in accordance with the formula contained in its certificate of incorporation. The sales by the taxpayer of its stock in 1937, 1938

and 1939 were made in order to raise much needed working capital. At the time of such sales, the taxpayer had available authorized but unissued stock which it could have sold. (R. 94–95.)

The taxpayer, in purchasing its own stock, handled the transaction on its books differently from the way it handled the purchase of other stock. In the purchase of other stocks, there was no change in the company's net worth but merely a change in form of assets, from dollars to investments. In the purchase of its own stock there was a reduction of the company's net worth in that the stock so purchased was not carried as an asset or as having any value, although it was not cancelled or retired. The company paid itself no dividends on such treasury stock. When the company sold its own stock so acquired, the excess of the proceeds over par went to surplus account, increasing the company's net worth. In the sale of other stocks the profit or loss therefrom went into income account. The sale of the treasury stock had the same effect on the books of the company as if unissued stock had been sold. (R. 95.)

The taxpayer declared a one hundred per cent (100%) stock dividend on June 17, 1940. This dividend was paid on June 18, 1940. The following is the resolution of the board of directors of the taxpayer declaring the dividend (R. 96–97):

> After motion duly made, seconded and unanimously adopted it was

> RESOLVED, That a 100% stock dividend in the stock of the Company be and the same hereby is declared on all stock of the Company, including Treasury stock, on record at 3:30 P. M. Eastern Daylight Saving Time on June 17, 1940, said dividend to be payable June 18, 1940; and
>
> FURTHER RESOLVED, that for the purpose of the foregoing resolution stock of record shall be deemed to include any share of stock which a purchaser shall have become obligated to purchase from the Company prior to the record date and hour, but for which no certificate shall have been issued at that time, and further that on any share which at the record date and hour the Company shall have become obligated to repurchase, such dividend shall be payable to the Company as in the case of Treasury stock; and
>
> FURTHER RESOLVED, that the par value $1.00 per share for the shares issued for such stock dividend (less the par value of shares payable on Treasury stock) be charged to paid in surplus.

Pursuant to the resolution, the taxpayer allocated 400 shares of its stock to treasury stock. (R. 97.)

The District Court (R. 97–99) and the Circuit Court of Appeals (R. 109–113) held that the Treasury Regulations covering the transaction were valid, and that the sale of taxpayer's repurchased stock at a profit constituted income within the meaning of Section 22 (a) of the Revenue Acts.

ARGUMENT

1. The decision of the court below is correct and does not involve any extension of the scope of the regulations (cf. Br. 11). The petitioner's contention (Br. 14, 17–18) that the sale of the Treasury stock to obtain working capital was only a capital transaction and that the regulations do not and cannot apply to such a situation has been rejected in *Allen* v. *National Manufacture & Stores Corp.*, 125 F. 2d 239 (C. C. A. 5th), certiorari denied, 316 U. S. 679. See also *Dow Chemical Co.* v. *Kavanagh*, 139 F. 2d 42 (C. C. A. 6th). Moreover, the contention is unsound. Working capital may be obtained by a sale of fixed assets which have appreciated in value, but no one would argue that income within the meaning of the Sixteenth Amendment has not been received.

The fact that the transaction may be treated as a capital transaction for accounting purposes is not controlling. That conservative accounting may relegate to capital what constitutionally is income or earnings or profits does not circumscribe the reach of the Revenue Acts. *Helvering* v. *Reynolds Co.*, 306 U. S. 110, 114. See also Section 115 (h) (1) of the Internal Revenue Code (26 U. S. C. 115); *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667; and *Commissioner* v. *Wheeler*, No. 354, October Term 1944, decided March 26, 1945.

Nor is there any merit to the contention that the situation is no different than it would be if the corporation had retired the repurchased stock and

issued authorized but previously unissued stock which, under the regulations, results in no income. Important legal and practical distinctions exist between the sale of treasury stock and the retirement of repurchased stock accompanied by the issuance of authorized but previously unissued stock. The purchase by a corporation of its shares without retirement enables it to avoid compliance with statutory or charter requirements that a reduction in capital stock be effected by vote of the board of directors and of the stockholders, and the filing of public notice; such purchase without retirement may also enable the corporation to sell the shares without observing the preemptive right of shareholders. A corporation which is enabled to secure these advantages by refraining from retiring its stock cannot properly urge that what it did was tantamount to retirement and reduction of capital and the subsequent issuance of newly authorized stock. (Cf. Br. 14.) Moreover, these advantages serve to point up the similarity between the transaction here and a transaction whose subject matter is the stock of another corporation, not taxpayer's own. See Article 22 (a)–16 of Treasury Regulations 94, *supra*, p. 3.

Finally, the decision of this Court in this case would not, contrary to petitioner's suggestion (Br. 11), afford an appropriate occasion for this Court to define the limitations of the regulations as applied to other situations.

2. The petitioner contends that Treasury Regulations, promulgated under earlier statutes and providing that a corporation realizes no gain or loss from dealing in its own shares, became so embedded in the law by the reenactment of the section defining gross income that the Treasury had no power to prescribe a different rule for the future and, hence, that Article 22 (a)–16 of Treasury Regulations 94, promulgated under Section 22 (a) of the Revenue Act of 1934, and the corresponding regulations under the Revenue Act of 1938 and the Internal Revenue Code are invalid. This Court has denied petitions for writs of certiorari in several cases in which substantially the same contentions have been made (see *Allen* v. *National Manufacture & Stores Corp.*, 125 F. 2d 239 (C. C. A. 5th), certiorari denied, 316 U. S. 679; *Commissioner* v. *Air Reduction Co.*, 130 F. 2d 145 (C. C. A. 2d), certiorari denied, 317 U. S. 681; *Helvering* v. *Edison Bros. Stores*, 133 F. 2d 575 (C. C. A. 8th), certiorari denied, 319 U. S. 752) and, there is no conflict on this issue. The validity of the amended regulations as applied to transactions consummated after the amendment[1] has been upheld in every circuit in which

[1] The Regulations were amended in 1934 by T. D. 4430, XIII–1 Cum. Bull. 36 (1934). In *Helvering* v. *Reynolds Co.*, 306 U. S. 110, this Court held the amended regulation invalid as applied to transactions consummated before the amendment, but did not pass upon its validity as applied to transactions effected thereafter.

the issue has been litigated and by the Court of Claims. In addition to cases cited above, see *Dow Chemical Co.* v. *Kavanagh,* 139 F. 2d 42 (C. C. A. 6th); *Wiegand Co.* v. *United States* (C. Cls.), decided May 7, 1945 (1945 C. C. H. Tax Service, par. 9286). Moreover, the power of the Treasury Department to make prospective amendments to Treasury Regulations, notwithstanding reenactment of the statute after the adoption of the prior regulation, has been firmly established by decisions of this Court. *Commissioner* v. *Wilshire Oil Co.,* 308 U. S. 90; *Helvering* v. *Reynolds,* 313 U. S. 428; *White* v. *Winchester Club,* 315 U. S. 32.

CONCLUSION

The decision below is correct, and there is no conflict which needs to be resolved nor any occasion for further review of the issue. The petition should therefore be denied.

Respectfully submitted.

HUGH B. COX,
Acting Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
HELEN R. CARLOSS,
LEONARD SARNER,
Special Assistants to the Attorney General.

JULY 1945.

U. S. GOVERNMENT PRINTING OFFICE: 1945